**In the High Court of Punjab and Haryana at Chandigarh**

**Income Tax Appeal No. 1 of 2003**

**Date of Decision: 21.01.2008**

Commissioner of Income Tax-I, Ludhiana. …Appellant.

VERSUS

M/s Vardhman Polytex Limited, Chandigarh Road, Ludhiana.

…Respondent.

**CORAM: HON'BLE MR. JUSTICE ADARSH KUMAR GOEL**
**HON'BLE MR. JUSTICE M.M.KUMAR**
**HON'BLE MR. JUSTICE RAJESH BINDAL**

Present: Sh.. S.K.Garg Narwana, Advocate
for the appellant.

Sh. M.S.Syali, Senior Advocate with
Sh. Satyen Sethi, Sh. Akshay Bhan and
Ms. Mahua C. Kalra, Advocates
for the respondent.

**RAJESH BINDAL, J.**

This matter was placed before us on account of different views expressed by this Court in **Commissioner of Income Tax v. Oswal Spinning and Weaving Mills Limited (1986) 160 Income Tax Reporter 426 (P&H)** and **Commissioner of Income Tax-1, Chandigarh v. Punjab Alkalies and Chemicals Ltd., Chandigarh (2006) 30 Indian Taxation Reports 247 (P&H)** by a Bench consisting two of us (Adarsh Kumar Goel and Rajesh Bindal, JJ). The order of reference reads as under:-

> "This is an appeal filed by the Revenue raising following substantial question of law, arising out of order dated 8.7.2002 passed by the Income-Tax Appellate Tribunal, Chandigarh Bench 'A', (for short 'the Tribunal'), for the assessment year 1992-93:
>
> "i) Whether on the facts and the circumstances of the case, the Hon'ble Income tax Appellate Tribunal was justified in deleting the addition of Rs. 1,97,290/- on account of interest and Rs.

9,80,000/- on account of upfront fees by ignoring Explanation 8 to Section 43(1)?"

The assessee, who is engaged in the business of yarn, filed its return of income for the year in question on 30.12.1992, declaring its taxable income at Rs. 3,59,86,351/. The return was processed under Section 143 (1)(a) of the Income Tax Act, 1961 (for short 'the Act') on 6.1.1992 at a total income of Rs. 3,60,04,130/-. The assessee thereafter filed revised return on 6.8.1993 declaring a taxable income of Rs. 3,48,09,071/-. In the computation of income filed along with revised return, the assessee claimed additional deduction on account of Rs. 1,97,290/- and Rs. 9,80,000/- on account of interest under Section 36(1) (iii) of the Act and upfront fees, respectively. This claim was made on account of loans raised for set up of a new unit at Baddi (HP). In the revised return a detail note was given at Serial No. 9 that the assessee has set up a new unit, for the purpose of which, the assessee incurred expenses on interest of loans and upfront fees of loan raised from financial institutions for establishing a new unit. It was admitted in the return that the new unit had not yet come into commercial production. However, the claim of the assessee was that the same is nothing but expansion of its earlier business under the same management and administration. The assessing officer, keeping in view, the admitted facts that the loan was raised for setting up a new unit for creating a capital asset which was yet come into production, the interest for the period prior to that could not be allowed as revenue expenditure for the purpose, Explanation 8 to Section 43 (1) of the Act which added retrospectively from 1.4.1974 was relied upon. Besides this, number of judgments of different High Courts were also referred to.

In appeal, learned CIT(A) accepted the plea of the assessee. While holding in favour of the assessee that the new unit at Baddi(HP) was part and parcel of the existing business of the assessee and it was only expansion of the already existing activity, the CIT(A) relied upon a judgment of Gujrat High Court in **Commissioner of Income Tax vs. Alembic Glass Industries Ltd.** [1976] 103 ITR 715, while distinguishing a judgment of this Court in **Commissioner of**

**Income Tax vs. Oswal Spinning and Weaving Mills Ltd.** [1986] 160 ITR 426.

The Tribunal, in appeal by the Revenue against the order of the CIT (A), approved the order passed by the CIT (A). While rejecting the appeal, the Tribunal recorded following findings:

> "24. On careful consideration of the rival submissions, we find force in the submission advanced on behalf of the assessee and are inclined to uphold the order of learned Commissioner of Income-tax (Appeals). As is evident from record, the assessee is carrying on business of manufacturing and spinning of yarn at Ludhiana and setting up a new unit for carrying on similar business at Baddi(HP). The Director's report and balance sheet clearly reflect that it is expansion of business earlier carried on by the assessee. The new unit at Baddi and old unit have common management and control, common funds interlacing and inter connection. The unit at Baddi cannot be held to be a new business. It is only expansion of old business. Interconnection of funds is established not only from the balance sheet but also from the fact that machinery and plant of old unit has been mortgaged to finance the new unit. The factual finding recorded by the learned Commissioner of Income-tax (Appeals) could not be challenged before us with reference to any material on record. The contention advanced on behalf of the Revenue that the learned Commissioner of Income-tax (Appeals) did not examine relevant question of common funds and common management and control, is not correct. As noted earlier, the plea on the above line was raised before the Assessing Officer and was not refuted in the assessment order. The Commissioner of Income-tax (Appeals) also examined the question is depth and decided the issue in favour of the assessee after elaborate discussion. We do not find any error in the approach of learned Commissioner of Income-tax

(Appeals). The view taken in the impugned order is not only supported by the decision referred to by the learned Commissioner of Income-tax (Appeals) but is also supported by fourteen decision given in the paper Books of the assessee, the latest in line, being the decision of Hon'ble Supreme Court in the case of CIT Vs. Associated Fibre & Rubber Industries (P) Ltd., 236 ITR 471. As it is a case of expansion of business, interest paid on borrowed funds for installation of machinery and upfront fees were rightly treated as of revenue nature and allowed. We confirm the action of learned Commissioner of Income-tax (Appeals)."

*(Emphasis supplied)*

The provisions relevant for consideration on the issue are extracted below:

**Other deductions.**

**"Section 36.**(1) the deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing referred to in section 28-

(i) xx xx

(ii) xx xx

(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession:

**Provided** that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

*Explanation.*- Recurring subscriptions paid periodically by shareholders, or subscribers in Mutual Benefit Societies which fulfil such conditions

as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause;"

**Definitions of certain terms relevant to income from profits and gains of business or profession.**

**43.** In sections 28 to 41 and in this section, unless the context otherwise requires-

(1) "actual cost" means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority:

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*Explanation 8.*- For the removal of doubts, it is hereby declared that where any amount is paid or is payable as interest in connection with the acquisition of an asset, so much of such amount a is relatable to any period after such asset is first put to use shall not be included, and shall be deemed never to have been included, in the actual cost, of such asset.

The undisputed facts in the present case are that the assessee, who was already continuing with its business at Ludhiana, started setting up of a new unit at Baddi (HP) for which the loans were raised from financial institutions on which the assessee was liable to pay interest besides payment of upfront fee. The new unit being set up at Baddi (HP) had not yet come into commercial production. The question for consideration in the present case is as to whether interest paid on borrowed capital for setting up of a new unit till such time it comes into commercial production, is deductible as the revenue expenditure under Section 36 (1)(iii) of the Act while computing the income of the assessee or to be treated as capital expenditure to be added to the cost of asset.

Section 43 of the Act defines certain terms relevant to determine the income from business or profession. Sub-section (1) thereof provides the definition of actual cost of an asset. Explanation 8 to Section 43(1) of the Act was added by the Finance Act, 1986 w.e.f. 1.4.1974. The object of the said amendment as contained in the Finance Bill, 1986 as it appeared in [1986] 158 ITR (St.) 88 is as under:

> "Under the existing provisions of clause (1) of that section, 'actual cost' means the actual cost of the asset to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority. The proposed amendment seeks to clarify that any amount paid or payable as interest in connection with acquisition of an asset and relatable to a period after the asset is first put to use shall not form part and shall deemed never to have been formed part of the actual cost of the asset."

A perusal of Explanation 8 of Section 43(1) of the Act and the object for which the same was inserted with retrospective effect shows that no interest paid or payable by the assessee in connection with the acquisition of the asset for any period after the asset is first put to use shall not form part (shall form part?) of the actual cost of the asset. The proposition in the present case is just reverse. The natural consequences of Explanation 8 would be that in case of any expansion, interest paid or payable on loans raised in connection with the acquisition of an asset before the same is first put to use shall form part of the actual cost of the asset. Meaning thereby that it will be capitalised to be added in the cost of the asset. Addition of Explanation 8 to Section 43(1) of the Act with retrospective effect from 1.4.1974 is a clear and ambiguous (unambiguous?). The same is in terms of the judgment of Hon'ble the Supreme Court in **M/s Challapalli Sugars Ltd. vs. CIT,** [1975] 98 ITR 167. In the said case, the expression actual cost under the Income-tax Act, 1922 was under consideration, which had not been defined therein. An identical issue therein was as to whether interest paid before commencement of

production on the amount borrowed for the acquisition and installation of plant and machinery has to be considered as part of the actual cost of the assets. Hon'ble the Supreme Court held that actual cost has not been defined in the 1922 Act, it was to be construed in the sense which no commercial man would misunderstood. While referring to and relying upon various principles and Rules on accountancy prevailing in the commerce and industries it was held that correct method for determination of the cost of capital asset is to include all expenditure necessary to bring such asset into existence and to put them in working condition. In case money is borrowed by a newly started company in the process of constructing and erecting its plant, the interest incurred before the commencement of production on such borrowed money can be capitalized and added to the actual cost of fixed assets which have been created as a result of such expenditure and such rule of accountancy should be adopted for determining the actual cost of the assets in the absence of any statutory definition or other indication to the contrary.

A perusal of Explanation 8 to Section 43(1) of the Act, referred to above, clearly shows that the same is nothing but reiteration of the principles laid down in M/s Challapalli Sugars' case (supra).

The expression does not make any distinction whether the asset is acquired by the assessee for setting up of an entirely new business or in the process of expansion of its existing business or industry. It merely provides for determination of actual cost of asset on a date when the asset first is put to use. Unless an asset, which is being acquired, starts generating income, it cannot be said that the same is being used for the purpose of business. Once it is established that interest paid after asset is put to use is not to be included in the actual cost on asset. There would be no alternate but to hold that the interest paid before the asset was first put to use would be included in the actual cost thereof and has to be treated as capital expenditure and not revenue in nature.

In **Oswal Spinning's** case (supra), this Court answered the question as to whether the interest paid by the

assessee on purchase of machinery should be considered as part of the cost of machinery. This Court held that the interest paid on acquisition of machinery should be treated as part of the cost of machinery while relying upon **Challapalli Sugar Ltd. v. CIT (supra); CIT v. Tensile Steel Ltd. (Guj.),** [1976] 104 ITR 581; **Ballarpur Paper and Straw Board v. CIT (Bom.)**, [1979] 118 ITR 613 and **CIT v. New Central Jute Mills (Cal.)**, [1982) 135 ITR 736.

While dealing with an identical issue, Calcutta High Court in **JCT Ltd. Vs. Deputy Commissioner of Income-tax and another** [2005] 276 ITR 115, decided the issue in favour of the Revenue and against the assessee by holding that even in cases of expansion of existing business, the interest paid or payable on the loans raised for acquisition of new asset would not be termed as revenue expenditure deductible under Section 36(1)(iii) of the Act. The conclusion drawn in the judgment is extracted below:

> "Having regard to the discussion and the question of law as discussed above, we are of the view that the interest paid on the borrowed capital under the deferred payment scheme for the period relevant till the asset was first put to use would not be eligible for deduction under section 36(1)(iii) or section 37 since it is includible in the actual cost of acquisition of the asset till the asset was first put to use, in view of Explanation 8 to section 43(1). Once the same comes within the purview of section 43 (1), Explanation 8, deduction under section 36 (1)(iii) or 37 cannot be claimed which stands clarified by the insertion of the proviso therein under the Finance Act, 2003. As such the assessee cannot claim any benefit of section 36(1)(iii) or section 37 in this case. The learned Tribunal was right in holding against the assessee.

Recently this Court had dismissed the appeal of the revenue in the case of **Commissioner of Income Tax-1, Chandigarh v. Punjab Alkalies and Chemicals Ltd.,**

(2006) 30 Indian Taxation Reports 247 (P&H) on a similar ground raised by the revenue.

In **Veecumsees v. CIT,** (1996) 220 ITR 185, Hon'ble the Supreme Court held that deduction for payment of interest on the loans raised for building a cinema theatre, which was ultimately closed, was allowable deduction as the assessee was engaged in a composite business of jewellery and cinema. The facts of the case are quite different with the facts of the present case.

Keeping in view the earlier judgment of this Court in **Commissioner of Income Tax v. Oswal Spinning and Weaving Mills Ltd. (supra)** and also the recent judgment of Calcutta High Court in **JCT Ltd. v. Deputy Commissioner of Income-tax and another** (supra), addition of proviso in Section 36(1)(iii) of the Act, in our view, the question raised in the present appeal is required to be heard by a larger Bench.

Accordingly, we direct that the papers be placed before Hon'ble the Acting Chief Justice for constituting a larger Bench".

2. The facts of the case in detail and relevant provisions of the Act have already been referred to in the reference order of Division Bench, and the same are not being repeated.

3. It is relevant to add here that proviso to Section 36(1)(iii) was added vide Finance Act, 2003 and the explanation 8 to Section 43(1) was added by Finance Act, 1986 w.e.f. April 1, 1974. The notes on clauses for addition of proviso to Section 36(1)(iii) and objects and reasons for amendment of Section 43(1), as reported in **(2003) 260 ITR 139 (st.)** and **(1986) 158 ITR 88 (st.)**, respectively, are extracted below:-

"Clause 15 seeks to amend Section 36 of the Income-tax Act relating to certain other deductions allowed under that Act.

Under the existing provision contained in clause (iii) of sub-section (1) of the said Section, deduction of interest is allowed in respect of capital borrowed for the purposes of business or profession in the computation of income under the head "Profits and gains of business of profession".

It is proposed to insert a proviso in the said clause so as to provide that no such deduction shall be allowed in

respect of any amount of interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books of account or not) and such amount of interest is for the period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use.

This amendment will take effect from Ist April, 2004 and will, accordingly, apply in relation to the assessment year 2004-2005 and subsequent years".

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"Memorandum explaining the provisions of the Finance Bill, 1986, reported as (1986) 158 ITR (St.) 88, at page 116, reads as under:

"MEASURES OR COMBATING TAX AVOIDANCE AND EVASION"

*'Actual cost' for the purposes of depreciation, investment allowance, etc.*

Under the existing provisions of section 43(1) of the Income-tax Act, 'actual cost' means the actual cost of the assets to the assessee reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority.

It has been found that certain taxpayers (backed by some Court decisions, the first of which was rendered on May 13, 1974) are resorting to a major change in accounting practice by capitalizing the interest paid or payable in connection with the acquisition of an asset relatable to the period after such asset is first put to use. This capitalization implies inclusion of such interest in the 'actual cost' of the asset for the purposes of claiming depreciation, investment allowance, etc. under the Income-tax Act.

As this was never the legislative intent nor does it conform to accept accounting practices, with a view to counteracting tax avoidance through this method and placing the matter beyond doubt, the Bill seeks to provide that any amount paid or payable as interest in connection with the acquisition of an asset and relatable to a period after the asset is first put to use shall not form part and shall

> be deemed never to have formed part of the actual cost of the asset.
>
> This amendment will take effect retrospectively from Ist April, 1974, and will, accordingly, apply in relation to the assessment year 1974-75 and subsequent years" (sic).

4. The proposed amendment seeks to clarify that any amount paid or payable as interest in connection with acquisition of an asset and relatable to a period after the asset is first put to use shall not form part and shall be deemed never to have been formed part of the actual cost of the asset.

5. In the above factual matrix, the following substantial question of law is required to be considered by this Court in the present appeal:-

> "Whether on the facts and the circumstances of the case, the Hon'ble Income tax Appellate Tribunal was justified in deleting the addition of Rs.1,97,290/- on account of ;interest and Rs. 9,80,000/- on account of upfront fees by ignoring Explanation 8 to Section 43(1)?"

6. We have heard Sh. S.K.Garg Narwana, Advocate, for the revenue, Sh. M.S.Syali, Senior Advocate with M/s Satyen Sethi, Akshay Bhan and Ms. Mahua C. Kalra, Advocates for the assessee and perused the paper book.

7. Learned counsel for the revenue while referring to the observations made by Division Bench of this Court, as extracted above, submitted that in the case in hand it is admitted that the assessee had acquired new assets for setting up a new unit. Even if the same was for expansion in the existing business being carried on by it, the same did not entitle it to claim deduction of the interest paid on the loans raised for acquisition of the new assets as a revenue expenditure. In terms of clear provisions of explanation 8 to Section 43(1) and Section 36(1)(iii) of the Act, the same was required to be capitalized towards the cost of the asset. The question that the assessee was setting up a new unit or was carrying out expansion in the existing unit is not relevant. The only fact relevant is that new assets have been created. It is not a case where some replacement was being made or modernization of the existing plant was made, which could be examined from a different angle. It is a clear-cut case where new unit was set up at a different location by buying new plant and machinery, though for producing same type of goods, which the assessee was already producing.

8. He further submitted that even the fact as to whether the unit was to be set up at a new location or at the same location would also be not material as such. He further submitted that the provisions of Section 36(1)(iii) and 43(1) of the Act cannot be read in isolation as firstly these are part of the same chapter, secondly Section 43 merely contains definition of certain terms relevant for determination of income from profits and gains from business or profession. He further submitted that view expressed by this Court in **Punjab Alkalies's case** (supra), whereby the appeal filed by the revenue on a similar substantial question of law was dismissed in limine, does not lay down good law and the substantial question raised by the revenue in the present appeal deserves to be answered in favour of the revenue and against the assessee by holding that in the facts & circumstances of the case the interest paid by the assessee on the loan raised for acquisition of new assets upto the date of its coming into production, was to be capitalized and cannot be claimed as revenue expenditure. He relied upon judgment of Hon'ble the Supreme Court in **Challapalli Sugar Limited's case** (supra) and this Court in **Oswal Spinning's case** (supra).

9. On the other hand, Sh. Syali, learned senior counsel appearing for the assessee submitted that the appeal does not raise any substantial question of law for the reason that concurrent findings of fact recorded by CIT(A) and the Tribunal have not been challenged by claiming any issue on perversity thereof. The appeal to this Court under Section 260 A of the Act, which is akin to Section 100 CPC, would lie only on a substantial question of law and once the same is not there, the appeal itself would not be competent. For the purpose, reliance is placed on **Mahalingappa v. C.M. Savitha (2005) 6 SCC 441, Rajeshwari v. Poran Indoria (2005) 7 SCC 60, State of Bombay (now Gujarat) v. Jagmohandas (1966) 60 ITR 206 (SC),** and **Ishwar Dass Jain AIR 2000 SC 426.**

10. On merits, it is submitted that admittedly the stand of the revenue is not that a new business was set up. The case of both the parties is that only new unit was set up in the same line of production. Meaning thereby the business remains the same. An additional or a new unit in the same business does not involve fresh computation of profits and gains of business or professional and once the business remains the same, the only conclusion is that whatever cost is incurred the same shall be allowable as revenue expenses. He further submitted that even where a loan or borrowing is utilized to purchase the capital asset or set up new unit, that does not itself mean that the interest thereon till the new asset/new unit comes into production cannot be claimed as deduction.

For the purpose, reliance is placed on **India Cements Ltd. v. Commissioner of Income Tax, Madras (1966) 60 ITR 52, Sivakami Mills Ltd. v. Commissioner of Income Tax, Madras (1979) 120 ITR 211, Bombay Steam Navigation Co. Ltd. v. Commissioner of Income Tax (1965) 56 ITR 52, Commissioner of Income-tax v. Malayalam Plantations Ltd. (1964) 53 ITR 140, Nathmal Bankatlal Parikh and Company v. Commissioner of Income Tax, A.P. III (1980) 122 ITR 168.**

11. Further submission is that there is a distinction between the borrowings made before the commencement of the business as such and after the commencement of the business. Whereas the interest paid before the commencement of the business is to be capitalised, however, if the same is after the commencement of the business the same is allowable as a revenue expenses. For the purpose, reliance is placed on **Challapalli Sugar Limited's case** (supra), **Sivakami Mills' case** (supra), **Ritz Continental Hotels Ltd. v. Commissioner of Income-tax Central-II, Calcutta (1978) 114 ITR 554, Addl. Commissioner of Income-Tax, A.P. v. Akkamba Testiles Ltd. (1979) 117 ITR 294, Addl. Commissioner of Income-Tax, A.P. v. Akkamamba Testiles Ltd. (1997) 227 ITR 464, Bombay Steam Navigation Co. (1953) Private Ltd. v. Commissioner of Income-tax, Bombay (1965) 56 Income Tax Reports 52, State of Madras v. G.J.Coelho (1964) 53 Income Tax Reports 186** and **Commissioner of Income Tax v. Dalmia Cement (Bharat) Ltd. (2000) 242 Income Tax Reports 129.**

12. Still further it is submitted that there is no difference in the legal position even after insertion of explanation 8 to Section 43 retrospectively, w.e.f. April 1, 1974. Reference has been made to para 18.2 of circular of the CBDT bearing No.461 dated July 9, 1986, which reads as under:-

> "It is an accepted accounting principle that where an asset is acquired out of borrowed funds, the interest paid or payable on such funds constitutes the cost of borrowing and not the cost of asset acquired with those funds. It is for this reason that as per the clear guidelines issued by the Institute of Chartered Accountants of India, the interest on moneys which are specifically borrowed for the purchase of a fixed asset may be capitalized only relating to the period prior to the asset coming into production, i.e., relating to the erecting state of the asset. However, once the production starts, no interest on borrowings for the purchase of such assets should be capitalized. In spite of these clear

guidelines, as also the consistent view of the Department in this matter, some taxpayers had adopted a contrary stance and had capitalized such interest".

13. Relying on above circular of the Board, the submission is that only object of the amendment was to restrict the claim of interest on the borrowings for creation of capital assets after the same is first put to use. Such interest was not to form part of the actual cost of the asset. The converse position that for period prior to the asset being first put to use shall form part of the cost of the asset is not provided in the explanation. He further submitted that explanation 8 to Section 43(1) of the Act cannot restrict the scope of Section 36(1)(iii) as Section 43 merely contains definitions, which are limited for grant of depreciation and investment allowance.

14. Learned senior counsel for the assessee further submitted that in fact the position has been made clear by the Legislature itself by adding proviso to Section 36(1)(iii) of the Act which takes care of such a situation and the amendment is w.e.f. April 1, 2004. This clearly means that for the period prior thereto, the position is different. The assessment year involved in the present appeal is 1992-93.

15. Having heard learned counsel for the parties, we find that there is no merit in the objection raised by learned counsel for the assessee to the effect that appeal does not raise any substantial question of law in the absence of challenge to the concurrent findings recorded by the CIT (A) and the Tribunal. In the case in hand with the admitted facts on record, the issue sought to be raised by the revenue is that whenever a new asset is created, may be in the form of expansion of the existing activity, the same has to be dealt with independently for the purpose of determination of its actual cost. The component of interest on the loans raised for the purchase of the asset is to be dealt with considering the same separately. The interest upto the date the asset is first put to use is to be added towards the cost of the asset and thereafter the same is to be claimed as revenue expenditure. This issue raised by the revenue, in our opinion, do arise for consideration in the present appeal even on the basis of the admitted facts. The perversity is not required to be raised as an issue. The loan in the present case was not raised for the purpose of running the business for its day to day requirements, rather the same was raised for the purpose of creating substantial additional assets by creating new capacity at a new location.

16. As far as the contention of the learned counsel for the assessee to the effect that the provisions of Sections 36 and 43 of the Act are to be read in isolation, we do not find any merit in the same. It is noticed that both Section 36 and 43 of the Act form part of the same Chapter, rather the same sub-part thereof dealing with profits and gains of business or profession. Section 43 of the Act contains definitions of certain terms relevant to the determination of income from profits and gains from business or profession. One of the definition in Section 43(1) is of the term "actual cost of the asset". The dispute in the present case is as to whether the interest paid by the assessee on the loans raised for acquisition of new asset, before the same was first put to use, is to be added towards the cost of the asset or the same is to be granted as a revenue expenditure for the reason that the assessee was already in business. Meaning thereby that in case the claim made by the assessee is accepted and the interest so suffered by the assessee is allowed as a revenue expenditure the same will not be added towards the cost of the asset. Whereas in case the claim of the revenue is accepted, the same would result in addition of the component of interest on the borrowed capital upto the date the asset is first put to use to the cost of the asset, accordingly, Section 43 of the Act cannot be left aside and the claim of the assessee cannot be considered merely by reading one provision of the Act and ignoring the other. The entire scheme of the Act is to be seen and all the provisions of the Act are to be read in conjunction with each other to achieve the underlined object. Accordingly, while rejecting the contention of the assessee, we do not subscribe to the view expressed by the Gujarat High Court in **Deputy Commissioner of Income Tax v. Core Healthcare Ltd. (2001) 251 ITR 61** wherein it was held that there is no connection between Sections 36 and 43 of the Act and the judgment is rendered on that premise.

17. As far as the issue on merits is concerned, the object of Income-tax Act is to charge tax on the income earned by an assessee by carrying on his business. The figure so arrived at should not be distorted by any factor. Section 28 provides for charging of income-tax on the profits and gains of business or profession carried on by the assessee under the head "Profits and Gains of Business or Profession". The business or profession is carried out by an assess with certain set up. The business would certainly mean the commercial activity being carried on by the assessee. While computing the income under the head "Profits and Gains of Business or Profession" certain deductions have been provided on account of expenses incurred by the assessee for earning such income

and certain special deductions for promoting the industrial activities. Section 36 of the Act provides for certain deductions while computing the income assessable under Section 28 of the Act under the head "Income from Profits and Gains of Business or Profession". Clause (ii) of Section 36 (1) of the Act provides for deduction of the amount of interest paid in respect of capital borrowed for the purpose of business or profession. This, in our view, will not bring within its fold the capital borrowed for the purpose of setting up of a new unit, may be in the same line, as the same would not amount to borrowing capital for the purpose of business or profession but for setting up of a plant, which is not the business of the assessee, rather it is the manufacturing activity. In case the plea raised by the assessee to the effect that the interest paid by it on the capital borrowed for the purpose of setting up of new unit is to be treated as capital borrowed for the purpose of business or profession, the same would result in distortion of the actual profits earned by the assessee in the business already being carried on by it. The new unit set up with the borrowed capital, the interest whereon is sought to be claimed as revenue expenditure, had not yet started contributing to the business carried on by the assessee. It is only when an asset is first put to use and commercial production starts then it starts generating income and it would be in the fitness of things in case the interest on the capital borrowed for the purpose of acquisition of that asset is allowed as a revenue expenditure only when such asset starts yielding income and not for any period prior thereto. For the period prior thereto the same has to be capitalised.

18. The issue as to whether the interest component on the capital borrowed for acquisition of the asset upto the date it is first put to use is to be added towards the cost of the asset or allowed as a revenue expenditure was considered by Hon'ble the Supreme Court in **Challapalli Sugar Limited's case** (supra). In this case, the assessee sought to raise the plea that the component of interest before the asset is first put to use is required to be added towards the cost of the asset, which was accepted. However, it is evident from the Memorandum explaining the amendment to Section 43 (1) made in 1986 that the issue as regards the capitalization of interest paid before the asset is first put to use stood already settled and was being followed by the assesses. The necessity to carry out amendment arose for the reason that in some judgments it was opined that interest even after the date the asset is first put to use is also to be capitalized. Amendment was carried out in Section 43(1) by adding explanation 8 thereto vide Finance Act, 1986 with retrospective effect from April 4, 1974. The text of explanation 8 has already been extracted above.

The true import thereof is that any amount paid or payable as interest in connection with an 'asset' which is relatable to the period after such asset is first put to use shall not be included in the actual cost of asset. The position in the present set of facts is just the converse. In the present case the dispute is regarding the interest so paid/payable for the period before the asset is first put to use. In our view the answer to even this issue is also implicit in the definition if it is to be given its full meaning. Accordingly, we hold that the interest so paid prior to the date the asset is first put to use is to be added towards the cost of asset and for that purpose reliance can well be placed on the enunciation of law by Hon'ble the Supreme Court in **Challapalli Sugar Limited's case** (supra), where such claim made by the assesses at the relevant time to the effect that interest paid on capital borrowed for the purpose of acquisition and installation of machinery for the period prior to the commencement of production should be capitalized, was accepted by Hon'ble the Supreme Court after considering its earlier judgment in **Indian Cement's case** (supra). The relevant passages from **Challapalli Sugar Limited's case** (supra) are extracted below:

> "The question:
>
> "Whether, on the facts and in the circumstances of the case, the assessee was entitled under the provisions of Sections 10 (2) (vi), 10 (2) (via) and 10 (2) (vib) read with Section 10 (5) of the Indian Income-tax Act, 1922, to treat the sum of Rs. 23,53,284 being the amount of interest paid on monies borrowed as part of the actual cost for the purposes of depreciation allowances and development rebate?"
>
> In appeal before us Mr. Palkhivala, on behalf of the assesses in the three appeals, has argued that interest for the period before the commencement of production on money borrowed for the purpose of acquiring and installing the machinery and plant should be included in the actual cost of the plant and as such capitalized for the purpose. As against that, Mr. Desai, on behalf of the revenue, has supported the view taken by the Andhra Pradesh High Court. After hearing the learned counsel for the parties, we are of the opinion that the submission made by Mr. Palkhivala is well founded".
>
> "It would appear from the above that, while considering the question of deduction on account of

depreciation and development rebate, we have to take into account the written down value. Written down value in its turn depends upon the actual cost of the assets to the assessee. The expression "actual cost" has not been defined in the Act, and the question which engages our attention is whether the interest paid before the commencement of production on the amount borrowed for the acquisition and installation of the plant and machinery can be considered to be part of the actual cost of the assets to the assessee. So far as the interest the commencement of production in respect of capital borrowed for the purpose of business is concerned, the same can be deducted under clause (iii) of sub-section (2) of Section 10 of the Act.

In finding the answer to the question mentioned above, we have to bear in mind that it arises in the context of profits or gains of business and the permissible deductions on account of depreciation and development rebate relating to the machinery and plant of the assessee. As the expression "actual cost" has not been defined, it should, in our opinion, be construed in the sense which no commercial man would misunderstand. For this purpose it would be necessary to ascertain the connotation of the above expression in accordance with the normal rules of accountancy prevailing in commerce and industry. The word "cost", as observed on page 4245 of *Simon's Taxes,* third edition, Vol. B, is not synonymous with "price". Other items of expenditure, such for instance as freight or warehouse charges or insurance, must in certain cases be added to the price. The matter has been dealt with in *Accountancy by Pickles,* 1955 ed., on page 944, under the head "Payment of Interest on Construction Capital" as under:

"In the ordinary course of affairs no dividends may be paid unless such dividends are paid out of profits : interest on debentures (being a charge) is, however, payable whether profits are earned or not. Where company raises share capital and out of the proceeds defrays the expenses of the construction of any works or buildings or provisions of plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is paid up for the period and may charge to

capital the sum paid by way of interest, provided that the restrictions imposed under Section 65 of the Companies Act, 1948, are complied with".

It is further observed :

"The interest so paid is 'capitalised', that is to say, it is treated as part of the cost of construction being added thereto (similarly to legal expenses of acquiring property or brokers' charges on purchasing investments)."

In *Spicer & Peglar's Practical Auditing,* 11th edition, it is observed on page 190-191, under the head "Interest Payable Out of Capital During Construction" :

"Interest on debentures issued for a similar purpose can be charged to capital during the period of construction (*Hinds v. Buenos Ayres Grand National Tramways Co. Ltd.)"*

In *Higher Book-keeping & Accounts* by Cropper Morris & Fison, seventh edition, it is observed as under:

"Capital expenditure over a long period must perforce involve the question of interest as an additional cost. If the work were undertaken by an independent contractor he would, of course, take interest into account when preparing the estimates on which to base his tender. The final cost of construction work is made up of the cost of the machinery, materials, labour, supervision and establishment charges, plus interest on the capital employed which, but for its employment in that way, would be invested in good securities paying a reasonable rate of interest."

Section 208 of the Companies Act, 1956 (1 of 1956), deals with the payment of interest on share capital in certain contingencies. Sub-section (1) of that section reads as under:-

"(1) Where any shares in a company are issued for the purpose of raising money to defray the expenses of the construction of any work or building, or the provision of any plant, which cannot be made profitable for a lengthy period, the company may –

(a) pay interest on so much of that share capital as is for the time being paid up, for the period and subject to the conditions and restrictions mentioned in sub-sections (2) to 7; and

(b) charge the sum so paid by way of interest, to capital as part of the cost of construction of the work or building or the provision of the plant".

Exercise of power under sub-section (1) is, however, subject to certain restrictions which have been enumerated in the remaining sub-sections of the section, one of which requires that no such payment shall be made without the previous sanction of the Central Government. In *Statement of Auditing Practices* issued by the Institute of Chartered Accountants of India (1974) it is observed in paragraph 2.5 as under:

"2.5. Fixed Assets should be valued at cost and depreciation should be written off on a proper and consistent basis. Cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. By way of illustration the following may be mentioned:-

(i) Legal charges and stamp duties in the case of land,

(ii) Architect's fees in the caste of buildings,

(iii) Wages, salaries and installation expenses in the case of machinery, and

(iv) Interest on borrowings to the extent specified in paragraph 2.22."

Relevant part of paragraph 2.22 reads as under:

"2.22. The question often arises as to whether interest on borrowings can be capitalized and added to the fixed assets which have been created as a result of such expenditure. The accepted view seems to be that in the case of a newly started company which is in the process of constructing and erecting its plant, the interest incurred before production commences may be capitalized. 'Interest incurred' means actual interest paid or payable in respect of borrowings which are used to finance capital expenditure. In no circumstances should imputed interest be capitalized, such as interest on equity or preference capital at a notional rate. Interest on capital during construction paid in accordance with the provisions of Section 208 of the Companies Act, 1956 may however, be capitalized as permitted by that section. Interest on monies which are specifically borrowed for the purchase of a fixed asset may be capitalized prior to

> the asset coming into production, i.e., during the erection stage. However, once production starts, no interest on borrowings for the purchase of machinery (whether for replacement or renovation of existing plant) should be capitalized…"
>
> It would appear from the above that the accepted accountancy rule for determining the cost of fixed assets is to include all expenditure necessary to bring such assets into existence and to put them in working condition. In case money is borrowed by a newly started company which is in the process of constructing and erecting its plant, the interest incurred before commencement of production on such borrowed money can be capitalized and added to the cost of the fixed assets which have been created as a result of such expenditure. The above rule of accountancy should, in our view, be adopted for determining the actual cost of the assets in the absence of any statutory definition or other indication to the contrary."

19. In **Sivakami Mills' case** (supra), Madras High Court quoted with approval a passage from the publication of the Institute of Chartered Accountants of India in the following terms:

> "Thus, it is clear from the cases considered above that an expenditure by way of interest or other charges incurred on borrowing of money for purchase of capital assets or other capital purposes, before the commencement of production or commencement of the business with the aid of such capital assets could be added to the cost of the assets. The passage from the publication of the Institute of Chartered Accountants of India has been sanctified by a judicial pronouncement and can now be taken as a guide in disposing of such claims. The said passage runs as follows ([1974] 95 ITR 284 at p. 294):
>
> "The question often arises as to whether interest on borrowings can be capitalised and added to the cost of fixed assets which have been created as a result of such expenditure. The accepted view seems to be that in the case of newly started company which is in the process of constructing and erecting its plant, the interest incurred before production commences may be capitalised. "Interest incurred" means actual interest paid or payable in respect of

> borrowings which are used to finance capital expenditure… Interest on capital during construction paid in accordance with the provisions of section 208 of the Companies Act, 1956, may, however, be capitalised as permitted by that section. Interest on monies which are specifically borrowed for the purchase of a fixed asset may be capitalised prior to the asset coming into production, i.e., during the erection stage. However, once production starts, no interest on borrowings for the purchase of machinery (whether for replacement or renovation of existing plant) should be capitalised. For an existing business, the only interest which may be capitalised is interest paid for financing a completely new unit or substantial expansion undertaken by the company. Even here only the interest on monies specifically borrowed for the new expansion may be capitalised and that only for the period *before production starts.'"* (underlined by us).

20. A Full Bench judgment of Kerala High Court in **Commissioner of Income-tax Kerala v. Travancore-Cochin Chemicals Limited (1975) 99 ITR 24** also dealt with the issue. In that case the assessee was an existing company engaged in manufacturing of caustic soda. It had an old 40 tonnes plant for the purpose. A new 60 tonnes caustic soda plant was acquired and installed by the company which commenced production from November 15, 1967. Though initially the Assessing Officer did not allow development rebate to the assessee by adding the interest in the cost of building. However, the Tribunal finally accepted the claim. On a reference sought by the revenue against the order of the Tribunal the question was answered in favour of the assessee by holding that the assessee was entitled to add the interest component incurred on the loans raised for setting up of plant, building and machinery. The following observations by the Full Bench would be relevant:-

> "We prefer the view taken by the Calcutta and Delhi High Courts. We are of the opinion that interest paid on borrowed capital, till the building, plant or machinery is erected or constructed, is part of the actual cost to the assessee within the meaning of Section 33 read with Section 43 of the Income-tax Act, 1961. This seems to us to be in accordance with both popular and commercial conceptions. Once it is recognized that a building, plant or machinery can be

> constructed or erected with borrowed capital, if the question be put : "How much did it actually cost you to build the house or to erect the plant or machinery?" we thing that the answer should include the interest on borrowed capital till the date of construction, or erection as the actual cost to the assessee. If actual cost would include interest on borrowed capital, one might well ask – as has been debated in some of the decisions noticed – whether interest should not enter into the reckoning of development rebate, till the liquidation of the debt, and not till the completion of the construction or erection. But decision seem to limit it to the date of commencement of business or completion of the building, plant or machinery……"

21. Considering the dictum of law laid down by Hon'ble the Supreme Court in **Challapalli Sugar Limited's case** (supra), Madras High Court in **Shivakami Mills Limited's case** (supra) and Full Bench of Kerala High Court in **Travancore-Cochin Chemicals Limited's case** (supra), a purposive interpretation is required to be given to Section 43(1) explanation 8 by holding that interest on the capital borrowed for acquisition of an asset for the period before the asset is first put to use is to be added towards its capital cost and for the period thereafter it is not permitted to be added towards its actual cost. The language of Section 43(1) explanation 8 does not in any manner makes out a distinction in the acquisition of an asset when a new business is being set up or when the expansion is being carried out. In fact, the addition of proviso to Section 36(1)(iii) of the Act is nothing else but clarifying the same underlined object in the scheme of the Act providing for the manner in which such an interest on the capital borrowed is to be dealt with.

22. Even a conjoint reading of Section 36(1)(iii) as existing prior to the proviso thereto and Section 43(1) explanation 8 clearly shows that any interest paid on the capital borrowed for the acquisition of an asset cannot be allowed as a revenue expenditure. The capital might have been borrowed by an assessee for the purpose of business. However, once it is admitted that a part thereof was used by the assessee for the purpose of acquisition of an asset, which is not in the form of replacement or modernization the interest component thereon upto the date it is first put to use has to be dealt with in terms of provisions of Section 43 (1) explanation 8 as otherwise cost of the asset shown in the balance sheet

will not depict its true picture. This is in conformity with law and the accounting principles.

23. Now we may deal with the effect of addition of proviso of Section 36(1)(iii) added vide Finance Act 2003. The import of addition of proviso to Section 36(1)(iii) is that the interest paid on the capital borrowed for the purpose of acquisition of an asset till the date such an asset is first put to use shall not be allowed as deduction. This is borne out as a converse proposition vide explanation 8 to Section 43(1) and a combined reading of Section 36(1)(iii) and Section 43(1) shows that the same is in consonance with the law laid down by Hon'ble the Supreme Court in **Challapalli Sugar Limited's case** (supra), wherein it is provided that any amount of interest paid on the capital borrowed for the purpose of acquisition of the asset upto the date it is first put to use is to be added towards the cost of the asset. Though proviso to Section 36(1)(iii) was added vide Finance Act, 2003 but in our opinion the same is merely clarificatory as it has made explicit what was already implicit.

24. A reading of memorandum explaining the amendment to Section 43(1) of the Act by way of insertion of explanation 8 thereto clearly shows that the same was carried out with the object to curb tax avoidance by the assessees by adding the interest paid on the capital borrowed for acquisition of the asset even after the asset had been put to use. The position converse was not required to be mentioned therein simply for the reason that an earlier judgment of Hon'ble Supreme Court in **Challapalli Sugar Limited's case** (supra) was already holding the field on the issue.

25. Learned senior counsel for the assessee has sought to raise a distinction in the cases where the new business was being set up and where the expansion of existing business was being carried out. However, a perusal of explanation 8 to Section 43(1) of the Act, no such distinction is carved out as it merely talks about payment of interest in connection with the acquisition of an asset. The business of the assess in the present case admittedly is to manufacture yarn and not setting up of plant and machinery to manufacture yarn.

26. The judgments relied upon by learned counsel for the assessee are not applicable in the facts and circumstances of the present case. In **Bombay Steam Navigation's case** (supra) the issue was as to whether the expenditure in question was revenue or capital in nature.

In **G.J. Coelho's case** (supra) the issue was only as to whether the interest paid by the assessee was an allowable deduction under Section 5(e) of the Madras Plantations Agricultural Income-tax Act, 1955 and not as to whether the same was to be capitalized or not.

A Delhi High Court judgment In **Dalmia Cement' (Bharat) Limited's case** (supra), is also distinguishable on the facts for the reason that there the borrowings were for modernization of an existing plant and not for setting up of a new plant.

27. For the reasons recorded above, the substantial question of law arising in the present appeal is answered in favour of the revenue and against the assessee. The Division Bench judgment of this Court in **Punjab Alkalies's case** (supra) is over-ruled.

The appeal is disposed of accordingly.

**(Rajesh Bindal)**
**Judge**

**(Adarsh Kumar Goel)**
**Judge**

**(M.M.Kumar)**
**Judge**

**January 21, 2008**
**"DK"**